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No. 03-1551

In the Supreme Court of the United States

FRANK BIEHL AND BARBARA BIEHL, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether attorneys' fees paid by petitioner Frank Biehl from the proceeds of a lawsuit against his former employer were incurred "in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement," so as to be deductible under Internal Revenue Code, 26 U.S.C. 62(a)(2)(A).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a) is reported at 351 F.3d 982. The opinion of the Tax Court (Pet. App. 11a-40a) is reported at 118 T.C. 467.

JURISDICTION

The judgment of the court of appeals was entered on December 12, 2003. The petition for rehearing was denied on February 10, 2004 (Pet. App. 10a). The petition for a writ of certiorari was filed on May 10, 2004. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Relevant portions of Section 62(a)(2) of the Internal Revenue Code (26 U.S.C.) and 26 C.F.R. 1.62-2 are set forth in the Appendix, *infra*, 1a-4a.

STATEMENT

1. Section 62 of the Internal Revenue Code, entitled "Adjusted Gross Income Defined," provides that certain trade or business expenses of employees are deductible in computing adjusted gross income. 26 U.S.C. 62 (2000 & Supp. I 2001). The provision at issue here, Section 62(a)(2)(A), includes in that category otherwise-deductible expenses incurred by the taxpayer "in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement." Section 62(c) adds a further condition to above-the-line deduction of such expenses, disqualifying them from such treatment if the plan does not require that they be substantiated or if the employee is permitted to retain amounts in excess of substantiated amounts.

Treasury Regulation Section 1.62-2 contains requirements for reimbursement or other expense allowance arrangements under Section 62(a)(2)(A) and (c) of the Internal Revenue Code. Arrangements meeting the regulatory requirements are called "accountable plans." 26 C.F.R. 1.62-2(c)(1) and (2). To simplify reporting, payments received under accountable plans are excluded from the employee's gross income and are exempt from payroll and withholding taxes. 26 C.F.R. 1.62-2(c)(4).

Treasury Regulation Section 1.62-2(d)(1) contains a "business connection" requirement. Echoing the language of Section 62(a)(2)(A), the regulation requires

that the arrangement reimburse only business expenses "that are paid or incurred by the employee in connection with the performance of services as an employee of the employer." 26 C.F.R. 1.62-2(d)(1).

2. Petitioners were shareholders in North Coast Medical, Inc. (NCMI), a family-owned and operated medical supply distributor. Petitioner Frank Biehl was also an employee of NCMI. Sometime prior to March of 1994, Mr. Biehl's employment at NCMI was terminated. Pet. App. 13a-14a. In March 1994, petitioners brought suit against NCMI alleging, *inter alia*, wrongful termination of Mr. Biehl's employment. On December 31, 1996, following a jury verdict in favor of petitioners, NCMI agreed to settle the claim for $1.2 million. NCMI issued a check to petitioners' attorneys in the amount of $401,000, which satisfied petitioners' attorneys' fees obligation, and issued a separate check to petitioners for the remaining $799,000 of the $1.2 million settlement amount. Petitioners reported only the $799,000 as income on their 1996 joint tax return. *Id.* at 2a.

The Commissioner determined that petitioners were required to include in their gross income the portion ($401,000) of their settlement that was paid directly to their attorneys and, accordingly, issued a notice of deficiency to petitioners. Although the Commissioner determined that the attorneys' fees qualified as a miscellaneous itemized deduction, see Internal Revenue Code, 26 U.S.C. 63, 67(b), petitioners did not benefit from this potential deduction because, in computing the alternative minimum tax (AMT), Section 56(b)(1)(A)(i) of the Code does not allow miscellaneous itemized deductions. Pet. App. 3a.

3. In the Tax Court, petitioners did not dispute that the entire amount of their settlement, including the

$401,000 paid directly to their attorneys, was includable in their gross income. They maintained, however, that a shareholders' agreement they had entered into with the other shareholders of NCMI constituted a "reimbursement or other expense allowance arrangement" within the meaning of Section 62(a)(2)(A) of the Code. On that ground, petitioners claimed they were entitled to deduct the attorneys' fees as a so-called "above-the-line" deduction to reach adjusted gross income, rather than as a so-called "below-the-line" itemized deduction. Because the income tax deficiency at issue resulted from the Commissioner's treatment of petitioners' attorneys' fees as a miscellaneous itemized deduction, the deficiency would have been eliminated if petitioners were correct in treating the attorneys' fees as an "above-the-line" deduction. Pet. App. 16a- 17a.

The Tax Court concluded that "Mr. Biehl's attorney's fee fails to satisfy the business connection requirement" of Treasury Regulation Section 1.62-2. Pet. App. 29a. The Tax Court adopted the Regulation's three-prong approach to determine whether a deduction is permitted under Section 62. A reimbursement arrangement is considered an "accountable plan," thereby rendering expenses incurred under the arrangement eligible for an above-the-line deduction, if it satisfies subsections (d), (e), and (f) of Treasury Regulation Section 1.62-2. Pet. App. 24a-25a. Subsection (d) incorporates the language of Section 62(a)(2)(A) in setting forth what is labeled the "business connection" requirement. Subsection (e), entitled "Substantiation," discusses the level of specificity necessary to properly identify the expense, and subsection (f), entitled "Returning amounts in excess of expenses," limits eligible arrangements to those that require the employee to return amounts in excess of actual expenses. The Tax Court held that the

failure to satisfy subsection (d)'s business connection requirement was dispositive, and thus the court did not reach the other two prongs. The Tax Court reasoned that "the touchstone of the employer-employee relationship is the employer's dominion and control over, or right to control, the services performed by the employee," and that where, as here, "the former employee is no longer under the dominion and control of the former employer, the expense cannot be properly characterized as having been 'paid or incurred by the employee in connection with the performance of services as an employee of the employer.'" *Id.* at 34a (citation omitted).

4. The court of appeals affirmed, holding that attorneys' fees paid in settlement of a wrongful termination suit do not satisfy the "business connection" requirement of Section 62(a)(2)(A). The court of appeals concluded that the Tax Court's decision is supported by "the plain language of the statute, the Treasury Regulations, and the legislative history surrounding both the enactment of the statute and subsequent revisions." Pet. App. 5a. The court explained that Congress's specific reference in Section 62(a)(2)(A) to the "performance" by the taxpayer of "services as an employee" "dictates that, in order to be deductible, the reimbursed expenses must be incurred during the course of employment" and "connotes duties carried out for, or on behalf of, the employer." *Id.* at 6a. Thus, because "Mr. Biehl was no longer performing services as an employee of NCMI" when he brought the lawsuit, "the statutory requirements of § 62(a)(2)(A) are not satisfied." *Ibid.*

The court of appeals observed that the "Treasury Regulations provide further support for the more narrow application of the business connection requirement." Pet. App. 7a. In particular, the court empha-

sized, subsections (b) and (d) of Treasury Regulation Section 1.62-2 add the proviso that the performance of services must be "as an employee *of the employer*," reconfirming that the expenses must have been "incurred on behalf of the employer within a current employment relationship." Pet. App. 7a. The court also found this understanding to be reinforced by the legislative history, which indicates that "Congress intended to limit the deduction [under Section 62(a)(2)(A)] to those situations where there was a current employer-employee relationship, and the expense was incurred on behalf of the employer." *Id.* at 7a-8a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. In their petition for certiorari, petitioners attempt to raise an issue not presented to or passed upon by the courts below, namely "whether, under Section 61(a) of the Internal Revenue Code, a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement." Pet. i. That issue is presented in two cases in which this Court recently granted certiorari, *Commissioner* v. *Banks*, cert. granted, 124 S. Ct. 1712 (2004) (No. 03-892), and *Commissioner* v. *Banaitis*, cert. granted, 124 S. Ct. 1713 (2004) (No. 03-907). As petitioners admit, however (Pet. 6), they did not dispute in either of the courts below that the portion of their recovery from their lawsuit against NCMI that was paid directly to their attorneys was includable in their gross income. Rather, they argued solely that their attorneys' fees were

deductible under Section 62(a)(2)(A), as an "expense[] paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer." Pet. App. 2a-4a, 12a, 16a-17a.

The question whether the portion of the damages award that was paid to petitioners' attorneys is includable in petitioners' gross income is entirely different from the question whether such fees are deductible as an employee business expense under Section 62(a)(2)(A). The former question involves the scope of the definition of "gross income," see Section 61(a), while the second involves whether the specific statutory conditions for a deduction are met. This Court ordinarily will not consider an issue not raised in or passed upon by the courts below. See *Yee* v. *City of Escondido*, 503 U.S. 519, 532-533 (1992); *Illinois* v. *Gates*, 462 U.S. 213, 218-220 (1983); *Tennessee* v. *Dunlap*, 426 U.S. 312, 316 n.3 (1976). Petitioners have provided no adequate grounds for the Court to depart from its normal practice in this case.*

2. As both of the courts below correctly held, petitioners' attorneys' fees plainly fall outside the scope of "expenses paid or incurred by the taxpayer, in connection with the performance of services by him as an employee, under a reimbursement or other expense allowance arrangement with his employer." 26 U.S.C. 62(a)(2)(A). The specific "business connection" requirement in this provision limits the above-the-line deduc-

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* In the event the Court were to conclude otherwise, the petition (limited to the newly raised exclusion issue) should be held and disposed of as appropriate in light of the disposition in *Commissioner* v. *Banks*, No. 03-892, and *Commissioner* v. *Banaitis*, No. 03-907.

tion to expenses that are incurred by employees on their employer's behalf and that are reimbursed in the normal course of an ongoing employment relationship. As the court of appeals cogently explained, attorneys' fees paid in settlement of a wrongful termination suit do not satisfy the business connection requirement contained in the statute and confirmed by the Treasury Regulations and the legislative history. Pet. App. 5a. When NCMI paid Mr. Biehl's attorneys' fees, it was not reimbursing an expense that Mr. Biehl incurred on the company's behalf in the course of performing services as an employee. He was no longer an employee when he sued, and his legal fees were not an expense incurred on behalf of the company, because the fees he incurred in suing NCMI served no business purpose of NCMI. The legal fees accordingly were not paid or incurred "in connection with the performance [by the taxpayer] of services as an employee." 26 U.S.C. 62(a)(2)(A). There is no conflict in the circuits on this issue, and petitioners do not assert such a conflict. Nor do they provide any other reason warranting further review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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APPENDIX

1. Internal Revenue Code (26 U.S.C. (2000 & Supp. I 2001)):

§ 62. Adjusted gross income defined

(a) General rule

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

* * * * *

(2) Certain trade and business deduction of employees

(A) Reimbursed expenses of employees

The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that the reimbursement may be provided by a third party shall not be determinative of whether or not the preceding sentence applies.

* * * * *

(c) Certain arrangements not treated as reimbursement arrangements.

For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement if—

(1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or

(2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

The substantiation requirements of the preceding sentence shall not apply to any expense to the extent that substantiation is not required under section 274(d) for such expense by reason of the regulations prescribed under the 2nd sentence thereof.

2. Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.62-2 Reimbursements and other expense allowance arrangements.

* * * * *

(c) *Reimbursement or other expense allowance arrangement*—(1) *Defined.* For purposes of §§ 1.62-1, 1.62-1T, and 1.62-2, the phrase "reimbursement or other expense allowance arrangement" means an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section.
* * *

(2) *Accountable plans*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an "accountable plan."

* * * * *

(4) *Treatment of payments under accountable plans.* Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax.) * * *.

* * * * *

(d) *Business connection*—(1) *In general.* Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by part VI (section 161 and the following), subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs a service as an employee of the employer, and may include amounts charged directly or indirectly to the payor through credit card systems or otherwise. In addition, if both wages and the reimbursement or other expense allowance are combined in a single payment, the reimbursement or other expense allowance must be identified either by making a separate payment or by specifically identifying the amount of the reimbursement or other expense allowance.

* * * * *

(e) *Substantiation*—(1) *In general.* An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See § 1.274-5T or § 1.162-17.

* * * * *

(f) *Returning amounts in excess of expenses*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time may amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances. An arrangement whereby money is advanced to an employee to defray expenses will be treated as satisfying the requirements of this paragraph (f) only if the amount of money advanced is reasonably calculated not to exceed the amount of anticipated expenditures, the advance of money is made on a day within a reasonable period of the day that the anticipated expenditures are paid or incurred, and any amounts in excess of the expenses substantiated in accordance with paragraph (e) of this section are required to be returned to the payor within a reasonable period of time after the advance is received.

* * * * *